SUPREME COURT, U. S.
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MICHAEL RODAK, JR., CLE

In The

Supreme Court of the United States

October Term, 1974

No. 74-1155

PENN-DIXIE CEMENT CORPORATION, JEROME CASTLE, OMAR J. GLANTZ, JAMES C. JACOBSEN, HARVEY KUSHNER, ALFONSO J. MARCELLE and JAMES F. MORRILL,

Petitioners,

vs.

JOHN SCHLICK, individually and on behalf of all purchasers of the common stock of Continental Steel Corporation similarly situated,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENT IN OPPOSITION

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OPINIONS BELOW AND JURISDICTION

The opinions below are set forth in petitioner's appendices A—C and the jurisdictional requisites are adequately stated in the petition.

QUESTIONS PRESENTED

1. Was the United States Court of Appeals for the Second Circuit correct in holding that a claim upon which relief may be granted is stated under Securities and Exchange Commission Rule 10b-5 by a complaint which alleges a fraudulent course of conduct contrived by a majority shareholder culminating in a merger with another company controlled by that majority shareholder and resulting in the merging out of minority shareholders at a manipulated and unfair exchange ratio?

2. Does the complaint properly plead a private claim on behalf of minority shareholders under Section 14(a) of the Securities Exchange Act and Rule 14a-9 thereunder?

STATEMENT OF THE CASE

Respondent sues on his own behalf and on behalf of all shareholders of Continental Steel Corporation ("Continental") similarly situated. The defendants below are Penn-Dixie Cement Corporation ("Penn-Dixie") and the directors of Continental and Penn-Dixie.

The action arises under the federal securities laws and has its genesis in the merger of Continental into a wholly owned subsidiary of Penn-Dixie.

Penn-Dixie caused the circulation of proxy material which initiated the corporate action culminating in the merger.[1]

In substance, it is alleged that Penn-Dixie, while owning 53% of Continental's issued and outstanding stock and with a compelling need on Penn Dixie's behalf to complete a merger embarked upon a plan and scheme by which Penn-Dixie and Continental (through Penn-Dixie's dominance of Continental's board) caused the intrinsic and market value of Continental's shares to be decreased and the value of Penn-Dixie's shares to be increased thereby facilitating the "merging out" of Continental's minority shareholders (including respondent) at an exchange ratio unfavorable to the Continental minority.

Three important facts relating to the Penn-Dixie-Continental merger must always be borne in mind. First, Penn-Dixie itself was under economic constraint to effectuate the

1. This writ is here upon the reversal of a judgment dismissing the action in the District Court for failure to state a claim. Accordingly, the factual allegations of the complaint must be assumed to be true. *Conley v. Gibson*, 355 U.S. 41 (1955).

merger. Pursuant to the terms and conditions of a loan agreement through which Penn-Dixie had borrowed $25,000,000, the loan would be accelerated to become due if the Penn-Dixie-Continental merger was not completed by June 30, 1973. Thus, while Penn-Dixie had obvious reasons for compelling the merger, the record is barren of any legitimate purpose for making Continental a merger partner. Secondly, a majority of the Continental board was vitally concerned with the continued economic well being of Penn-Dixie since they were Penn-Dixie nominees. Thirdly, while the merger exchange ratio gave Continental minority shareholders a value of approximately $17 per share (Penn-Dixie's estimate), Penn-Dixie was carrying its 53% interest in Continental at approximately $42 per share. Thus, if Penn-Dixie had placed a value upon its own holdings even approaching the substantially lower exchange ratio, generally accepted accounting principles would have required the amortizing of the excess of cost over asset value which, in turn, would have resulted in Penn-Dixie sustaining a very substantial dimunition of earnings (or loss) in the year of the merger and a substantially lower book value. Penn-Dixie thus had established a double standard in the valuation of Continental stock, dependent wholly on whose hands that stock was in.

The essence of the complaint is that there are two intertwined wrongs. First, that in connection with the merging out of the Continental minority, the defendants engaged in a course of conduct which was designed to and did have the effect of altering the exchange ratio upon the merger to the detriment of the Continental minority thus constituting a violation of Rule 10b-5. Second, this scheme or artifice to defraud culminated in

the issuance of false and misleading proxy material. This proxy material is an element of the overall scheme to defraud and also constitutes the basis for a claim for violation of §14(a) of the Securities Exchange Act of 1934, and Rule 14a-9 thereunder.

The components of the scheme to take unfair advantage of the Continental minority constitute both overt acts and in turn, elements of nondisclosure in the proxy material. See opinion below, 507 F.2d at 378-9.

At all times, Penn-Dixie had the power, through its stock ownership, to carry the merger question at the Continental shareholders' meeting. It is this fortuitous state of facts upon which petitioners urge reversal, but as the court below held, naked power is not enough to excuse violations of federal securities laws.

ARGUMENT

Introduction

In the name of advocacy, the petitioners have placed the cart before the horse. We shall attempt to place the issues before this Court in their proper order and in a realistic perspective.

Petitioners devote the vast majority of their petition to the claim arising under Rule 14a-9 (the "Proxy Rule" claim) while giving short shrift to the Rule 10b-5 claim. Admittedly, the Proxy Rule claim and its relationship to the so-called *Mills* open question (see, *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 385, n. 7 (1970)) is of academic interest. See, *e.g.*, Note, *Causation and Liability in Private Actions for Proxy Violations*, 80 Yale

L.J. 107 (1970). A resolution of that open question, however, will have no effect whatsoever upon the respective rights of the parties. It is submitted that, even assuming that the Proxy Rules claim was never even included in the complaint, the respondent and the class he seeks to represent would nontheless have a good and valid claim against Penn-Dixie and the individual defendants pursuant to Rule 10b-5. For this reason we follow the chronology of the court below and turn first to the Second Circuit's approval of the Rule 10b-5 claim and the propriety thereof.

The Rule 10b-5 Claim

The court below has concluded:

> "Thus, the complaint completes the showing necessary to state a claim under Rule 10b-5. It alleges a specific scheme to defraud (a scheme which includes the proxy solicitation as a part, but which included substantial collateral conduct as well); the fraud was accomplished in connection with a securities transaction; the appellant was a seller in that transaction; and as a result of the sale, appellant alleges a loss was sustained." 507 F.2d at 381.

It is respectfully submitted that this conclusion falls well within the parameters of existing and long settled law and is congruent with the decisions of this Court and of the Courts of Appeals which have construed the Rule. Indeed, the Rule 10b-5 claim is sustainable and was sustained below without reference

to *Mills, supra,* and its open question. The Rule 10b-5 portion of the decision below is in the mainstream of the evolution of the law in this field as reflected by decisions of this Court and of the Second Circuit Court of Appeals. See, *Affiliated Ute Citizens v. United States,* 406 U.S. 475 (1972); *Superintendent of Insurance v. Bankers Life & Casualty Co.,* 404 U.S. 6 (1971); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 495 F.2d 228 (2d Cir. 1974); *Laurenzano v. Einbender,* 448 F.2d 1 (2d Cir. 1971); *Chasins v. Smith Barney & Co.,* 438 F.2d 1167 (2d Cir. 1970); *Globus v. Law Research Services, Inc.,* 418 F.2d 1276 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970); *Heit v. Weitzen,* 402 F.2d 909 (2d Cir. 1968), *cert denied,* 395 U.S. 903 (1969); *List v. Fashion Park, Inc.,* 340 F.2d 457 (2d Cir.), *cert. denied,* 382 U.S. 811 (1965).

Any analysis of the Rule 10b-5 claim must begin with the holding of this Court that a violation of the Rule may derive from the improper use of the proxy solicitation process. *SEC v. National Securities, Inc.,* 393 U.S. 453 (1969).

The petition before this Court misperceives the issues before the court below and distorts that court's holding.

The real issue before the Second Circuit on the Rule 10b-5 question was one of causation. See 507 F.2d at 380. The opinion below does not, as contended in the petition, break new ground in the Rule 10b-5 field. There is nothing new or earthshaking in this decision. At the threshhold the court below was putting ". . . to rest . . . a slow to die contention" that Rule 10b-5 governs fraud in the securities market place only and that it should not extend to those misdeeds which are arguably

actionable under state law. First of all, regardless of whether state law might afford a remedy "where Rule 10b-5 properly extends, it will be applied regardless of any cause of action that may exist under state law." *Popkin v. Bishop*, 464 F.2d 714, 718 (2d Cir. 1962)[2] quoted at 507 F.2d 379-80.

Indeed as this Court has stated:

> "Since there was a 'sale' of a security and since fraud was used 'in connection with' it, there is redress under §10(b), *whatever might be available under state law. Bankers Life, supra* at 168 (emphasis added)."

Relying upon decisions of this Court and upon other decisions within the Second Circuit, the court below found the requisite causation in fact. There is no better way to establish the propriety of the decision below than to quote from it:

> "This is not a case where the 10b-5 claim is based solely upon material omissions or misstatements in the proxy materials. Were it so, concedely there would have to be a showing of both loss causation — that the misrepresentations or omissions caused the economic harm — and transaction causation — that the violations in question caused the appellant to engage in the transaction in question. The former is demonstrated rather easily by proof of some

2. Although injunctive relief was denied in *Popkin*, a claim for damages is still being pursued via a class action not unlike the one at bar. See *Popkin v. Wheelabrator-Frye, Inc.*, par. 94, 091 CCH Fed. Sec. L. Rptr. 1973 Transfer Binder (S.D.N.Y. 1973).

form of economic damage, here the unfair exchange ration, which arguably would have been fairer had the basis for valuation been disclosed. Transaction causation requires substantially more. In a misrepresentation case, to show transaction causation, a plaintiff must demonstrate that he relied on the misrepresentations in question when he entered into the transaction which caused him harm. . . . In an omission or nondisclosure case based upon Rule 10b-5, a plaintiff need not show reliance in order to show transaction causation but must still show that the facts in question were material 'in the sense that a reasonable investigator might have considered them important' in making his investment decisions.

Under the 10b-5 count, proof of transaction causation is unnecessary by virtue of the allegations as to the effectuation of a scheme to defraud which includes market manipulation and a merger on preferential terms, of which the proxy omissions and misrepresentations are only one aspect. Thus appellant need only show loss causation with respect to his claim for relief under 10b-5; Judge Metzner found and we agree that this has been shown. Here the complaint clearly alleges that, as a result of the merger, appellant was forced to sell his Continental shares to Penn-Dixie on the basis of an exchange ratio that reflected adversely the manipulated

> market value of Continental stock, and that he sustained injury accordingly." (507 F.2d at 380-1; citations and footnotes omitted.)

Petitioners now argue that the decision below and particularly the above quotation permits conversion of state law grounded wrongs into Rule 10b-5 claims.

This is not the case because the complaint alleges and the court below rightfully assumed that the acts done by petitioners leading up to the merger[3] were performed with a view toward affecting a change in the merger ratio. The statement by petitioners (Petition 18) "But neither *Bankers Life* nor any other decision of this Court has done away with the requirement that there must be what has been consistently defined as fraudulent or deceptive conduct, rather than acts of corporate mismanagement such as are alleged here," is the classic straw man, neatly constructed; quickly dispatched. It has, however, no relationship to the issues of this case. Petitioners appear to confuse deception or for that matter, non-disclosure with the concepts of "new fraud" found in Rule 10b-5. Yet the "forced seller" concept is well ingrained in Rule 10b-5 and actionable misconduct under the Rule exists whether or not the forced seller makes a cognitive choice or whether or not he pursues or forebears from pursuing a volitional course of conduct in connection with his sale.

Rule 10b-5 speaks in the disjunctive and one of its proscriptions is:

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3. *I.e.*, Alteration of Continental's accounting methods, use of Continental's funds as compensating balances for Penn-Dixie's loans, artificial inflation of Penn-Dixie's book value. See 507 F.2d at 378-9.

> "(3) to engage in act, practice or course of business which operates or would operate as a fraud or deceit upon any person."

It is this portion of the Rule which is invoked here; and this portion of the Rule is operative even when conduct is disclosed, but the reasons for the conduct are not. It is axiomatic that the "deception" which petitioners claim is lacking, may always be found in fully disclosed acts which are not unlawful (much less actionable under state law) when the acts are performed for an unlawful purpose. *O'Neil v. Maytag,* 339 F.2d 764 (2d Cir. 1964); *Cochran v. Channing Corp.,* 211 F. Supp. 239 (S.D.N.Y. 1962). The requirement of deception in those cases was satisfied through the finding that a lawful act was done for an unlawful purpose. Thus, the District Court in *Cochran v. Channing, supra,* 242-3 stated as follows:

> "In the instant case the complaint charges more than a simple failure to disclose . . . . It alleges that as part of the scheme to increase its holdings of Agricultural the defendants caused a reduction of the dividend so as to depress the price of the stock. Plaintiff relies upon this affirmative act in support of the complaint.
>
> The fact that the defendants did not make any statements at all does not, in and of itself, deprive plaintiff of relief. The three subsections of Rule 10b-5 are in the disjunctive, and while subsection (2) seems to require a statement of some sort, subsections (1) and (3) do not. One who causes a

> reduction of dividend in order more cheaply to purchase the shares of a corporation is most certainly employing a device to defraud and is engaging in a course of business which operates as a fraud upon the seller of those securities."

Thus, like *Cochran* and the myriad cases which follow it, the case at bar presents a Rule 10b-5 claim based upon the perpetration of at least arguably lawful acts performed for an unlawful purpose; the merging out of the Continental minority. Of course, this concept despite the protestations of Penn-Dixie is not particularly new to our jurisprudence. See, *e.g., United States v. Rabinowich,* 238 U.S. 78 (1914); *Bannon v. United States,* 156 U.S. 464 (1895); *Sundry Goods, Wares and Merchandises (American Fur Company) v. United States,* 27 U.S. (2 Pet.) 355 (1829).

The use of lawful means to effectuate a result actionable under Rule 10b-5 has recently been passed upon in *Bryan v. Brock & Blevins Co.,* 343 F. Supp. 1062 N.D. Ga. 1972), *aff'd,* 490 F.2d 563 (5th Cir. 1974). There a corporation was set up by the majority shareholders of a closely-held corporation for the sole purpose of "merging out" a minority shareholder.

As the District Court stated (343 F. Supp. at 1070):

> "The proposed merger itself was a course of business which would operate as a fraud or deceit upon [the minority shareholder] in connection with the sale of his stock . . . . To allow Brock & Blevins [the corporation engineering the merger]

> to arbitrarily select a time in which to forcefully exclude a minority's interest through unlawful employment of an apparently lawful procedure is not to be condoned by this Court."[4]

It is appropriate to, at last, halt the continual waving of the "bloody shirt" of state law remedies to ameliorate the predicament of the Continental minority. The plain facts are that no such remedies exist! A derivative Rule 10b-5 action challenging the transactions here at issue has been dismissed on grounds of lack of capacity to sue derivatively after the merger had been consummated, (*Schlick v. Castle,* 74 Civ. 1623 [S.D.N.Y.] opinion of Marvin Frankel, U.S.D.J., January 15, 1975). It is quite clear that Judge Frankel's decision would act as a bar to a state law derivative action as well, as his decision turns on a question of the capacity to sue under Indiana law (Continental's state of incorporation). In substance, a federal claim based upon an implied right of action under the federal securities laws brought through the vehicle of a class action is the *only* way to test the propriety of the Continental Penn-Dixie merger and its effect upon the Continental minority.

What then does the Rule 10b-5 portion of the decision below stand for? Certainly it represents no radical departure from existing law.

The case stands for no more than the following:

4. The case at bar presents an even more extreme set of facts than *Bryan, supra.* Here, as noted in the opinion below, 507 F.2d at 382, the Continental minority did not even have the option of state law appraisal under Indiana law. Penn-Dixie securities were literally forced down their throats.

(a) That Rule 10b-5 will be applied in appropriate cases whether or not such a case is actionable under state law. For this proposition, there is ample authority in *Bankers Life, supra,* and *Popkin v. Bishop, supra.*

(b) That a causal relationship exists between the injury to merge out minority shareholders and a scheme to alter intrinsic and market values in preparation for a merger. This too is grounded upon existing law. *Affiliated Ute Citizens, supra; Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., supra.*

To summarize, the issues raised by the Rule 10b-5 claim do not involve mere claims of mismanagement, but rather acts involving a scheme anticipatory of the merger. Nor should the fact that a proxy solicitation was an element of the wrong lead to the confusion that causation here is related in any way to the *Mills* open question. The solicitation function of the challenged proxy material has no bearing on this side of the ledger. The issue is not the approval of the merger, but rather the underlying reasons for effecting the merger in the first instance, and the terms foisted on the Continental minority.

The Proxy Rules Claim

As noted above, this Court in *Mills, supra,* left open the definitional question of whether a sufficient quantum of causation exists in a private Proxy Rules claim where the proponent of the question submitted for shareholder approval owned the requisite shares to carry the question.

The court below has answered that question by finding that causation in fact exists whether or not arithmetical certainty exists with respect to the outcome of the shareholder vote.

The decision of the Court of Appeals should be left undisturbed.

As the court below pointed out (507 F.2d at 383):

> "In the end, we must remember the 'broad remedial purposes' of the Securities Act. *J.I. Case Co. v. Borak*, 377 U.S. 426, 431, 84 S. Ct. 1555, 12 L. Ed. 2d 423 (1964); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195, 84 S. Ct. 275, 11 L. Ed. 2d 237 (1963). Indeed, Mills itself, while leaving the question open, as we have pointed out, by holding that there was a sufficient causal relationship in a proxy case by proof that the proxy solicitation itself rather than the particular defect in the solicitation materials was an essential link in the accomplishment of the transaction, 396 U.S. at 385; 90 S. Ct. 616, lends some support to a more moderate view of transaction causation."

The court below rejected out of hand, the imposition of a "but for" causation standard[5] to private rights of action brought pursuant to the Proxy Rules. By doing so, the decision below chooses to follow the principle first established by this Court in *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964). *Borak* teaches us that the securities laws and the rules adopted pursuant to those laws

5. This standard of causation is to be found in *Barnett v. Anaconda Co.*, 238 F. Supp. 677 (S.D.N.Y. 1967) and its progeny. These cases, overruled by the instant case, stood for the proposition that so long as the results of a shareholder vote were predetermined because of the existence of a majority shareholder-proponent of the question, a private right of action under Rule 14a-9 was not stated because of lack of causation.

work to establish a framework of broad remedies for those involved in securities transactions.

Should this Court re-institute the arithmetical approach to causation espoused by the petitioners, that framework would be seriously undermined. The legislative intent underlying the securities laws was that common law remedies were insufficient to protect investors and others involved in securities transactions from the "morals of the market place."

It would therefore be a step backward to apply a common law tort standard when such a standard had long ago been found inadequate.

Boiled down to its essential terms, petitioners protest that the decision below creates liability in the air, but as the Second Circuit Court of Appeals stated "in a very real sense, shareholders were deceived by the action of those making the corporate decision to merge." 507 F.2d at 382.

Petitioners argue that the Second Circuit's decision constitutes an abandonment of the concept of causation as an element of the wrong sued upon. This is entirely incorrect. What the Second Circuit has done is abandoned "but for" or "arithmetical" causation for a new standard of causation exemplified by the decision in *Affiliated Ute Citizens, supra.* There is causation in the case at bar. As the Court below stated:

> ". . . we are of a view that *sufficient causation* is alleged so that the complaint must not be dismissed." 507 F.2d at 384 (emphasis added).

It is clearly established then, that rather than abandoning causation as an element of the wrong, the Second Circuit has simply opted for a definition of causation which is entirely appropriate when applied to an implied right of action under the Federal securities laws.

The direction of this Court to its subordinate federal courts in *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964) was to fashion federal remedies for the invasion of federally created rights. As was pointed out by the court below:

> "Affiliated Ute holds that causation is established by a material omission when there is a duty to disclose." 507 F.2d at 384.

What petitioners seek on this petition, therefore is nothing more than a review of the definitional standard adopted by the Second Circuit in conformity with the mandate of this Court in *Borak* and *Affiliated Ute*. It is clear that that definitional standard is eminently correct and should not be disturbed.

The legislative purpose underlying federal scrutiny of proxy solicitation would, as the court below pointed out, be subverted if such scrutiny is deemed meaningless when minority votes are not necessary to carry proposed shareholder action.

> "The equities call for the protection of the minority shareholder when he is most helpless, as when [as here] neither disinterested director nor disinterested shareholder voting exists as a safeguard. To require strict causation would

> sanction all manner of fraud and over-reaching in the fortuitous circumstance that a controlling shareholder exists . . ." 507 F.2d at 383 (citations omitted).

Upon analysis, what petitioners also ask this Court to do is to engraft onto the Proxy Rules, a precondition to the bringing of an action which would require a showing that the injured party surrendered rights extrinsic to the solicitation process because he was deceived by the inadequacy of the soliciting material (*i.e.*, had the truth been disclosed, he would have sought an injunction or sought appraisal).

First of all, such a showing is made in the case at bar. While, the Continental minority had no right of appraisal (507 F.2d at 382), they had the right to go into the marketplace to sell. The circulation of a false and misleading proxy statement had the effect of locking the price of Continental stock into a ratio of Penn-Dixie's, both of which prices, the complaint alleges, were manipulated to create a patina of fairness in the merger.

Therefore, the acts leading up to the circulation of the proxy material and the circulation itself, had the effect of depriving the Continental minority of the fair price of their stock. Thus "but for" the acts complained of, Continental shares would be worth more. The Continental minority must therefore be deemed to have surrendered the fair value of their shares because of the violation.

In any event, and as an abstract principle, there should be no requirement that the damaged minority shareholder be

volitionally involved in his injury (such as in common law fraud). There is a broad statutory and administrative scheme here to be given effect and the teeth in that network of protection is the right to pursue a private right of action. The target of such an action is not exonerated merely because he has the naked power to achieve a given result. Simply stated, neither §14(a) of the Securities and Exchange Act nor Rule 14a-9 do away with the requirement of full and fair disclosure where a majority stockholder exists. To do away with the liabilities which flow from a breach of that requirement where such a majority stockholder exists "... would make the proxy requirements a farce." 507 F.2d at 383.

Finally, petitioners urge that the decision below is in conflict with the decisions of another Circuit, *Swanson v. American Consumer Indus., Inc.*, 415 F.2d 1326 (7th Cir. 1969) *(Swanson I)* and 475 F.2d 516 (7th Cir. 1973) *(Swanson II)*. The decisions, however, are harmonious. The essence of the *Swanson* decisions are the statements in *Swanson I* 415 F.2d at 1331-2

> "The power to effect a given result does not negative all possibility of injury resulting from the fraudulent or manipulative use of that power."

and the Court's statement:

> "We are not prepared to sanction a rule of causation which would presume that full disclosure to minority shareholders could have no transactional function in corporate affairs." *Id.* at 1332.

Petitioners beg the question when they quote from *Swanson II* to the effect that ". . . causation between the deception and injury has not been established. . . ." 475 F.2d at 518, since the *Swanson* decisions define causation as a duty to disclose coupled with an omission to disclose, together with economic damage. Such a holding conforms not only with the decision of the Court below, but with the decision of this Court in *Affiliated Ute Citizens, supra.* There is no conflict between the circuits.

CONCLUSION

The petitioners call this action a "strike suit" (Petition 12) and "legalized blackmail" (Petition 18). The Continental minority would say that this action represents an attempt to remedy the effects of as blatant a corporate rape as one could imagine. But epithets, regardless of their derivation, are of no assistance in the resolution of lawsuits. We are here merely testing the sufficiency of the complaint. The decision of the Second Circuit was eminently correct. Its decision on the Rule 10b-5 claim followed a well trod course and does not represent a departure from existing law. The decision on the Proxy Rules claim is consonant with the evolution of the law in that field, represents no conflict with the decisions of any other circuit and should be left undisturbed. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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